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THE APPLICATION OF EXCHANGE NETWORK THEORY TO THE  
ANALYSIS OF FOREIGN DIRECT INVESTMENT IN  
THE PEOPLE'S REPUBLIC OF CHINA

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By

Keric Blaine On Chin

Thesis Committee:

Alvin Y. So, Chairman

Paul Clark

Eldon Wegner

We certify that we read this thesis and that, in our opinion, it is satisfactory in scope and quality as a thesis for the degree of Master of Arts in Sociology.

## THESIS COMMITTEE

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Chairman

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## TABLE OF CONTENTS

ACKNOWLEDGEMENTS.....	v
LIST OF TABLES.....	vi
LIST OF ILLUSTRATIONS.....	vii
CHAPTER I. INTRODUCTION.....	1
CHAPTER II. THEORIES TOWARD A NEW EXCHANGE NETWORK	
MODEL.....	5
Dependency and World System Perspectives...	5
Exchange Theory and Interorganizational	
Relations.....	9
Theoretical Framework: Exchange Network	
Model.....	11
Power.....	14
Strategies.....	20
Summary of Exchange Network Model.....	26
CHAPTER III. THE CHINESE CONTEXT..	30
CHAPTER IV. METHODOLOGY.....	46
CHAPTER V. RESULTS AND DISCUSSION.....	50
Productive Exchange Relations.....	52
Capital Relations.....	66
Input Relations.....	78
Labor Relations.....	84
Land Relations.....	90
Output Relations.....	93

Availability Codes	
Dist	Avail and/or Special
A-1	

CHAPTER VI. CONCLUSIONS.....	98
APPENDIX.....	105
REFERENCES.....	109

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## LIST OF TABLES

I	Total Foreign Investment in China.....	41
II	Summary Of Power Differentials In Exchange Relations.....	99
III	Summary Of Strategies Employed By Foreign Investors In Study.....	100

## LIST OF ILLUSTRATIONS

## Figures

## Page

- 1 Foreign Investment Environment: Exchange  
Network Model..... 29



## CHAPTER 1

### INTRODUCTION

The establishment of an "open door" policy in 1978 marked China's return to the capitalist world-economy. The self-reliance policies of the Maoist era were renounced in favor of modernization. As such, China has adopted a vigorous program of attracting foreign investments. Foreign investors responded favorably to China's invitation and over the course of the past ten years thousands of direct investment projects, particularly joint ventures, were set up. Recently, however, the investment atmosphere has soured. Many foreign investors, like the American Motor Company, have found it increasingly difficult and less beneficial to establish ventures in China,

The goal of the present study is to examine why foreign investors are facing a more difficult time in China. What obstacles are investors encountering in their investment relationships? Why are they unable to overcome these obstacles? What strategies have they used? We hope that current sociological theory as presented in this paper will be able to shed light on many of these questions.

Foreign investment in Third World countries has typically been studied from an aggregate level perspective.

The dependency and world system perspectives have been the most prevalent of these in recent times. These political economy perspectives claim to provide a framework through which capitalist penetration can be analyzed; each one examining the core-periphery relations in the capitalist world economy from a different vantage point. (Koo, 1984; So, 1986). According to Nash (1981), "the central dynamic of the world system remains that of maximizing the accumulation of surplus in the core countries on the basis of inequalities in exchange relations with the rest of the world" (p.401). Exchange relations are therefore central to explanations of international imbalances.

However, the dependency and world system perspectives do not provide an adequate analysis of the specific factors and processes influencing exchange relations in the world system; rather, they are limited to the analysis of more aggregate level phenomena such as the development of economic, class, and social structures in response to capital penetration. As such, they are unable to examine direct investment on a micro organizational level.

To fill the void left by the dependency and world system literature, the present study proposes that an exchange network model be used to analyze the micro-level

integration of foreign direct investment into Third World countries, and in particular socialist countries. Such a model would focus on individual foreign investment organizations as part of a network of exchange relations. Foreign investors engage in the exchange of resources--money, workers, raw material, etc.--with other organizations within their environment. Power differentials develop as a result of an organization's exchange relations and its position in the exchange network. The various activities undertaken by foreign investment companies such as coalition formation, network extension, or withdrawal must be examined in relation to their power in a network and the benefits they derive from participation. Our exchange network model also pays attention to the relevant environmental factors, such as the state and the class structure, present in the world economy. An organization's power within a micro exchange network is bound to be affected by its relationship to the macro environmental factors in the world system.

This study contributes by taking an original micro-level approach to understanding the problems facing foreign investors by examining the relationship between individual foreign investors (New Zealand and U.S.) and the Chinese class structure and state. The primary goal of the present study is to determine whether a foreign

investor's activities, including its success or failure in China, can be explained by an exchange network model rather than by mere cultural differences. In order to do this, we will first develop a general picture of the foreign investment environment based on the exchange network model, and subsequently determine which strategies investors find most useful in it. It is hoped that this study will provide insight into the actual processes by which companies succeed or fail to establish foreign ventures, and on the dynamics of capital penetration into a socialist country.

## CHAPTER 2

## THEORIES TOWARD A NEW EXCHANGE NETWORK MODEL

Dependency theory and the world system perspective are the primary frameworks through which capitalist penetration (i.e. foreign investment and foreign financing) into the Third World has been studied in recent times. However, these perspectives do not lend themselves to a micro-level analysis of direct investment. In this chapter, we will attempt to fill the gap left by these aggregate level theories by incorporating exchange network theory into the larger framework they have already set up. We shall briefly consider the basic propositions behind the dependency and world system perspectives, and discuss how exchange network theory can extend our analysis of foreign direct investment to an organizational level.

## Dependency and World System Perspectives

Dependency theory was first articulated by Andre Gunder Frank (Trimberger, 1979). Frank contended that Third World countries are not undeveloped but rather underdeveloped because of their economic dependence on advanced capitalist countries, the so-called metropolis (So, 1981). The economic structures of the core capitalist countries and the peripheral dependent countries are seen

as part of a larger world system. According to Dos Santos (1970), dependency and underdevelopment emerge when the economies of certain countries become subjected to the development and expansion of another economy. The "penetration of core capital into the peripheral economy is believed to have a powerful conditioning effect on the economy, class structure, and ultimately the entire social structure of a dependent country" (Koo, 1984, 35). The primary concern of dependency theorists is the unilateral relationship between core and peripheral countries. Consequently, dependency theorists explain the internal conditions of peripheral countries in terms of their relationships to core countries (So, 1981).

Wallerstein (1979) argued for a higher level of analysis than was provided by dependency theory. He proposed that the world, and not unilateral relations, become the primary unit of analysis. This world system perspective "stresses the independent significance of the world capitalist system and its impact on socioeconomic processes in all nations--core, peripheral, or semiperipheral" (Koo, 1984, 36). According to Wallerstein, the capitalist world-system is both dynamic and cyclical in nature. So (1986) points out that Wallerstein's model has an additional semi-periphery layer between the core and periphery which makes it possible for countries to

experience upward and downward mobility. Unlike the overly deterministic dependency model, countries within the world system paradigm can move from the core to the semi-periphery and from the semi-periphery to the periphery, and vice versa. The capitalist world-system also experiences periods of expansion and contraction due to the imbalance of world effective demand and world supply of goods (So, 1986). Consequently, the internal conditions of any peripheral or core country can be understood in terms of its position in the world economy (Koo, 1984; So, 1986).

The world system model proposed by Wallerstein was largely inspired by Frank (Nash, 1981). Nash has noted that the concept of exchange relations is of central importance to the Wallerstein and Frank model of the world system. For them, exchange relations account for international imbalances. The relative bargaining power of producing units in the world system depends upon the scarcity or abundance of products it exchanges on the world market. Furthermore, "a nation's structural location within a pattern of [exchange] relations crucially determines a wide range of its putatively national characteristics" (Friedmann, 1988, p. 304). Analysts have

demonstrated this in the areas of economic growth, urbanization, income distributions, political regimes, and revolutionary transformations.

The analytical frameworks developed by Wallerstein and Frank and extended by others have been concerned to a large extent with capital penetration into Third World countries. (see Amin, 1974; Cardoso, 1972; Cardoso and Faletto, 1979; Dos Santos, 1970; Frank, 1967; Nash, 1981; So, 1981, 1986; Trimberger, 1979; Wallerstein, 1974) Unfortunately, the fact that these perspectives focus on aggregate level phenomenon, such as social, class, and economic structures, limits their usefulness in the analysis of more micro-level phenomenon. A major component of the dependency and world system perspectives--the exchange relation--is therefore neglected; the theories never spell out how empirically to analyze exchange relationships. Consequently, these frameworks are forced to gloss over the specific and intricate processes by which foreign direct investment becomes integrated into Third World countries because of their inability to adequately address the actual dynamics of exchange relations among world actors.



## Exchange Theory and Interorganizational Relations

The present study suggests that foreign direct investment be studied from an interorganizational exchange theoretical perspective. The rationale behind such an approach is quite simple. First of all, organizations are the primary actors engaged in foreign direct investment. An analysis of direct investment would naturally focus on interorganizational interactions. According to Cook (1977), Turk has contended that the fruitfulness of past organizational approaches has prompted the question, "Is the organization not the proper unit in the analysis of modern, large scale social systems?" (p. 63).

Secondly, an approach based on interorganizational exchange theory would pick up where dependency and world system theory leave off. As previously discussed, exchange relations are an important part of the world system model; yet, the dependency and world system frameworks are not able to adequately address them. Interorganizational exchange theory, on the other hand, is ideally suited for the analysis of such relations.

Theories of organizational exchange relations are largely based on the works of Emerson (1962), Blau (1964), Homans (1958), and Thibault and Kelley (1959). These

earlier works have dealt for the most part with exchange relations among individuals, but have since been adopted for the analysis of organizations. In the past two decades, the exchange theoretical framework introduced by Levine and White (1961) and extended by Thompson (1967) and Jacobs (1974) has emerged as the dominant approach in discussions of interorganizational relations (Cook, 1977). However, Cook (1977) criticized these theorists, as well as others, for using exchange notions simply to "provide a loose conceptual framework for analyses" (p. 63). She has noted the lack of a systematic application of exchange theory to interorganizational relations.

Cook has made an important contribution to the study of interorganizational relations by recognizing that organizations are actors in a network of exchange relations, and by analyzing interorganizational activities in relation to an organization's power and position in a network. There are essentially two components in Cook's exchange model: the dyadic exchange relation itself, and the interorganizational network. Previous works on the application of exchange theory to interorganizational relations have tended to focus on either the exchange relation itself (Levine and White, 1961; Jacobs, 1974) or the interorganizational network (Benson, 1975), but not on both.

The present study develops the areas of exchange relations and interorganizational networks within the context of foreign direct investment by drawing upon Jacobs' (1974) work on exchange relations and Benson's (1975) political economy model of interorganizational networks in addition to Cook's exchange model. Furthermore, this study attempts to extend Benson's (1975) conception of interorganizational environments by including dependency and the world system as the relevant environment.

#### Theoretical Framework: Exchange Network Model

As Cook (1977) pointed out, there are several definitions of exchange. Levine and White (1961) in their study of relationships among health and welfare agencies defined exchange "as any voluntary activity between two organizations which has consequences, actual or anticipated, for the realization of their respective goals" (p. 588). Cook criticized Levine and White's definition of exchange as being too broad. Furthermore, it lacks the element of mutual reinforcement or reward. She proposed a definition of interorganizational exchange based on Emerson's work:

"An exchange relation (e.g., Ax;By) consists of voluntary transactions involving the transfer of resources (x,y,...) between two or more actors (A,B,...) for mutual benefit." (Cook, 1977, p.64)

The term "actor" in this definition refers to both individuals and collective actors such as organizations or corporate groups. The term "resource" applies to any valued activity, service, or commodity. This definition of an exchange relation will be utilized in the present study.

Cook (1977) argued that organizations seek to reduce the uncertainty in their environments by engaging in exchange relations. Uncertainty is fostered by such factors as scarcity of resources, and lack of perfect knowledge of environmental fluctuations, of the availability of exchange partners, and of available rates of exchange. In other words, "organizations seek to reduce environmental uncertainty by creating 'negotiated' environments" (Cook, 1977, p. 65).

An organization's exchange relations exist as part of a larger network of exchange relations. Emerson (1981) defined an exchange network as "a set of two or more connected exchange relations" (p.50). He further stated that "two exchange relations are connected to the degree

that exchange in one relation is contingent upon exchange (or nonexchange) in the other relation" (p.50). An interorganizational field consists of many, possibly overlapping, exchange networks (Cook, 1977). Cook argued that the degree of overlap of exchange networks could be used as an indicator of organizational interdependence, and thus environmental complexity. High levels of organizational interdependence, in turn, could be used as a predictor of high levels of interorganizational activity. That is, the probability that some instigative event will produce interorganizational activity is greater due to the increased probability that actors in overlapping networks will come into contact with one another. (Cook, 1977).

Network connections can be characterized along two dimensions according to Emerson's typology: bilateral or unilateral, and positive or negative. The terms bilateral and unilateral refer to the direction of flow in two connected exchange relations, and the terms positive and negative refer to the contingency of one exchange relation on the other. For example, "Two exchange relations are bilateral negatively connected if linked by an inverse function such that an increase in the frequency or magnitude in one exchange relation leads to a decrease in the frequency or magnitude of exchange in the other (or

vice versa). The relation is unilaterally negatively connected if the inverse contingency is one-directional" (Cook, 1977).

### Power

The activities of individual foreign investors must be examined in relation to their power in exchange networks. Many of the actions taken by foreign investors, and organizations in general, are contingent upon the amount of power they can bring to bear in an exchange relation. Power is determined by both the nature of the exchange relationship itself and the position of organizations in an exchange network. (1) Within an exchange relation, the power of one organization is determined by the other's dependence upon it with respect to two factors: resource alternatives and resource essentiality (Jacobs, 1974). (2) Power derived from the interorganizational network can be divided into two broad categories: that originating from an organization's position in an internal network structure, and that originating from external linkages.

## Power in Exchange Relations

Emerson (1962) equated an actor's power in an exchange relationship with the dependence of the other actor. Thus, for example, the power of actor A over actor B ( $P_{ab}$ ) is equal to the dependence of actor B on actor A ( $D_{ba}$ ):  $P_{ab} = D_{ba}$ . Dependency, according to Emerson, varies according to the alternatives an actor had outside the exchange relationship, and according to the degree of motivational investment an actor had in the resource provided by the exchange partner. In the exchange relationship  $Ax;By$ , B is dependent upon A to the extent that B cannot obtain resource x from an outside source, and to the degree that B is motivated toward that resource. Moreover, A is dependent upon B to the extent that A cannot obtain resource y from an outside source, and to the degree that A is motivated toward that resource. In other words, dependency can be a two-way street. Power differentials are a reflection of the balance of dependency in exchange relations with the power advantage equal to  $P_{ab} - P_{ba}$ .

Jacobs (1974) adapted Emerson's use of power and dependency to an organizational setting and pointed out five points at which organizations can become dependent on their environment. The points of dependency are input acquisition, output disposal, capital acquisition,

acquisition of production factors (i.e. land), and acquisition of a labor force. Conventional definitions of production factors include land, labor, and capital in one category, but Jacobs argued that it is more useful to separate them since they are often sources of conflicting demands on an organization. The dependencies which are most problematic for an organization are those resource dependencies for which an organization has limited access to alternative suppliers and for which an organization is not willing to substitute.

The concept of substitutability, which equates to Emerson's motivational investment, refers to the essentiality of a resource to an organization. According to Jacobs, what proves essential is a function of the organization's goals and time. For example, foreign investors have traditionally set up organizations in developing countries which emphasize labor-intensive technology. Thus, they would find it difficult to substitute for labor. organizations supplying labor, such as unions or government agencies in a socialist setting, therefore have power in the exchange relation. On the other hand, the foreign investor may opt to mechanize its organization and therefore reduce the essentiality of labor, and consequently undermine the power of the labor supplier.



The relationship between substitutability and alternatives is interactive (Jacobs, 1974). A dependency would not be difficult to manage if the exchange relation was based on either an unessential resource or there were many alternative sources. A dependency becomes problematic and can result in power differentials when the exchange relation is based on both an essential resource and there are limited alternatives. Jacobs points out that the inverse is true when an organization sells commodities to its environment to meet a dependency. In this situation, an unfavorable power differential results when there are multiple sellers of a commodity and the commodity is not essential to the buyer(s). This concept of exchange relations may help us to understand why foreign investors have failed to control the Chinese market.

#### Power in Interorganizational Networks

Power differentials also arise because of interorganizational networks. "Exchange networks represent the flow of resources within a social structure of 'connected' exchange relations" (Cook, 1982, p. 195). The key to an organization's power is its ability to effect this flow of resources. According to Benson (1975), power can be divided into two broad categories: internal network

structure and external linkages. The former category refers to power derived from an organization's position in a network. Often times, centrality of position affords an organization the greatest power (depending upon the types of exchange relations involved, i.e. positive or negative). This is because all resources must flow through that organization. Thus, all other actors in the network are dependent upon that central actor. The key consideration here is an organization's position and its ability to affect the flow of resources by virtue of that position.

The exchange network itself is embedded within a larger environment. Because the external environment frequently conditions interorganizational networks, organizations can gain power through their linkages to it. Benson (1975) described the external environment of networks as being composed of organizations, such as lobbies, government bureaus, and foundations; officials such as legislators; and publics, such as reform advocates. However, Benson's definition seemingly limits the environment of organizations to a national level. In contrast, political economists would argue that the relevant external environment extends beyond individual nations to the world capitalist economy (Wallerstein, 1974). An analysis of foreign investment ventures must

necessarily consider power in relation to external linkages with organizations, officials, and publics on both the national and world level.

Benson notes that the difficulty with the idea of environment is discerning those aspects of it which are most relevant to the network. However, three relevant areas of the world capitalist economy can be identified: the state, the internal class structure, and world conditions (Koo, 1984). (1) The state is "a crucial connecting link between social and economic relations at both domestic and international levels, and the pattern of development in these countries" (Koo, 1984, p. 48). Consequently, organizations with links to the state power centers will have considerable power over interorganizational networks. These links may be to state bureaucratic offices, to state parties, or to officials within these entities. (2) Linkages with the internal class structure are also important. Specific classes can exert pressure on the state, and thus the exchange network in support of their particular interests. In socialist countries (e.g. Peoples Republic of China), ties with the emerging managerial bourgeoisie may be an important source of power for foreign investors. (3) The world system conditions must be considered. For foreign investors, the world system not only offers alternative markets, but it

also offers linkages to foreign states, including the foreign investor's home state. These linkages may in turn be used to influence the host state. In sum, "the effects of state policies and policy implementation seem direct and immediate, whereas those of social class and international capital, as powerful as they are, tend to express themselves largely through major state policies and actions of the state" (Koo, 1984, p. 48).

### Strategies

This section deals with the strategies organizations take in relation to power differentials in their exchange networks. Strategies, like organizational power, can be divided into two related (and sometimes overlapping) categories. The first set of strategies involve the individual exchange relationships themselves. These are the "power balancing processes" (or power unbalancing processes as the case may be): withdrawal, network extension, status giving, and coalition formation (Cook, 1977; Emerson, 1962). The focus of the second set of strategies is specifically the interorganizational network and the flow of resources through it. These include cooperative strategies, disruptive strategies, manipulative strategies, and authoritative strategies (Benson, 1975). Organizations engage in the above

strategies in order to secure the necessary resources for their functioning. As Cook suggests, these strategies are as likely to be used by the dominant organizations in a market as they are by the less powerful actors.

Organizations invoke power balancing strategies in an attempt to reduce the power or control of other organizations over their exchange relationships (Cook, 1977). These power balancing processes work by addressing the two components of power (dependency) in an exchange relationship, alternatives and substitutability. The following balancing operations are proposed for organizations (in exchange relation  $Ax;By$ ):

1. Withdrawal: a decrease in the essentiality of a resource  $Y$  for organization  $A$ .
2. Network Extension: an increase in the number of alternatives available to organization  $A$ .
3. Status-Giving: an increase in the essentiality of resource  $X$  for organization  $B$ .
4. Coalition Formation: a decrease in the number of alternatives for organization  $B$ .

Operations 1, 2, and 4 are of particular interest to the study of foreign investment. The first balancing strategy is withdrawal. Foreign investors who find

themselves at a power disadvantage-- that is, dependent upon another organization for an essential resource-- can reduce their dependency by finding a substitute for that resource. In an example given previously, labor was an essential resource (i.e. nonsubstitutable) for an organization which relies upon labor intensive technology. The organization which supplied labor consequently exercised power in the exchange relationship to the extent that there were limited alternatives. However, this power imbalance could have been minimized if the organization converted to a mechanized process, thereby reducing the essentiality of labor. In today's world, the essentiality of certain raw materials has been reduced because of synthetic substitutes produced by modern technology.

A power imbalance can also be reduced (or created) by finding alternatives. This is known as network extension. Foreign investors may seek alternative suppliers or buyers of a specific type of resource ("exchange category") in both the local and world market. By gaining access to alternatives, an organization decreases its dependency upon any single other organization operating within a specific exchange category. A car manufacturer who seeks out alternative suppliers of steel is exercising network extension. Market expansion may also be viewed as a form of network extension. Companies that

have access to several markets can reduce their dependence on any single market. In other words, companies value profit, and the more markets a company has, the less uncertain it will be about obtaining that resource.

The fourth strategy is coalition formation. Coalition formation acts to reduce power differentials by limiting alternatives. In the exchange network B1---A---B2, organization A has a power advantage since B1 and B2 must compete with one another for exchange with A. If B1 and B2 form a coalition, (B1,B2), then the dependency of A on the coalition (B1,B2) is greater (Cook, 1977). The B's gain power by reducing A's alternatives. Cook notes that in a situation where B1 and B2 possess multiple resources (y1, y2, y3...etc) that are needed by A, a reduction in alternatives can also occur if B1 and B2 specialize. For example, if organization B1 agrees to produce and exchange resource y1 with A, and B2 agrees to produce and exchange y2 and y3, then B1 and B2 avoid competition and organization A loses its exploitative position.

The above power balancing mechanisms deal more or less with individual exchange relations. Benson (1975) suggested four additional strategies which focus exclusively on the flow of resources in a network.

Cooperative strategies are agreements between parties that "involve a process of negotiation and exchange through which each party has voluntarily given up some valued condition in exchange for similar concessions on the part of others" (Benson, 1975, p.241). These agreements may cover a wide range of products or behaviors from the exchange of facilities, funds, and personnel to agreements to cease disruptive activities. The key to this type of strategy is that each organization hold something of value for the other and be capable of resisting the other's demands (Benson, 1975). Obviously, cooperative strategies are effective only for the duration of a contract.

The second major strategy proposed by Benson is the disruptive strategy. This "involves the purposive conduct of activities which threaten the resource-generating capacities of a target agency" (Benson, 1975, p.242). Disruptive strategies tend to undermine the necessity and legitimacy of target agencies. They are more applicable to relationships between government agencies than to foreign investment ventures and will not be discussed here.

However, a very important type of strategy available to foreign investors is the manipulative strategy. This strategy "involves the purposeful alteration of the environmental constraints affecting the



flow of resources" (Benson, 1975, p.243). Two aspects of the flow of resources are targeted: the volume of resources and the resource channels. Benson claims that this tactic is "analogous to governmental regulation of the economy through manipulation of interest rates, tax rates, and money supply" (p. 243). The state is the primary manipulative power in the network environment. Therefore, organizations may influence the flow of resources by use of their external linkages. Specifically, linkages directly with the state or indirectly through the class structure may enable organizations to manipulate the resource flow (e.g. state policy).

The final type of strategy, the authoritative strategy, simply refers to the authoritative alignment or realignment of networks by actors such as government bodies, executive offices, and judicial bodies. Power is used to mandate precise activities, not merely encourage or reward those activities. In fact, manipulative strategies are aimed at influencing the authoritative powers of state participant bodies. These strategies are particularly important in a socialist setting since the central government exercises a substantial amount of power over the economy.

### Summary of Exchange Network Model

In sum, the investor's environment is characterized by five sets of dependency relationships: input, output, labor, land, and capital. These relationships are in turn embedded in a larger network of relations, and the network itself is conditioned by the external environment. That is, the state and particular classes within it are capable of conditioning the structure and nature of an investor's relationships. For example, the state may limit the number of suppliers from which an investor may purchase raw materials, or may hamper the actual flow of resources between the investor and the supplier by imposing administrative restrictions.

Moreover, since direct investment often involves the formation of joint ventures, we can identify one more exchange relationship in addition to the five already mentioned--the relationship that exists between the partners in a joint venture. This particular relationship differs slightly from the others in that it is a productive exchange relationship as opposed to a simple exchange relationship. According to Marsden (1987), a productive exchange exists when "resources possessed by different

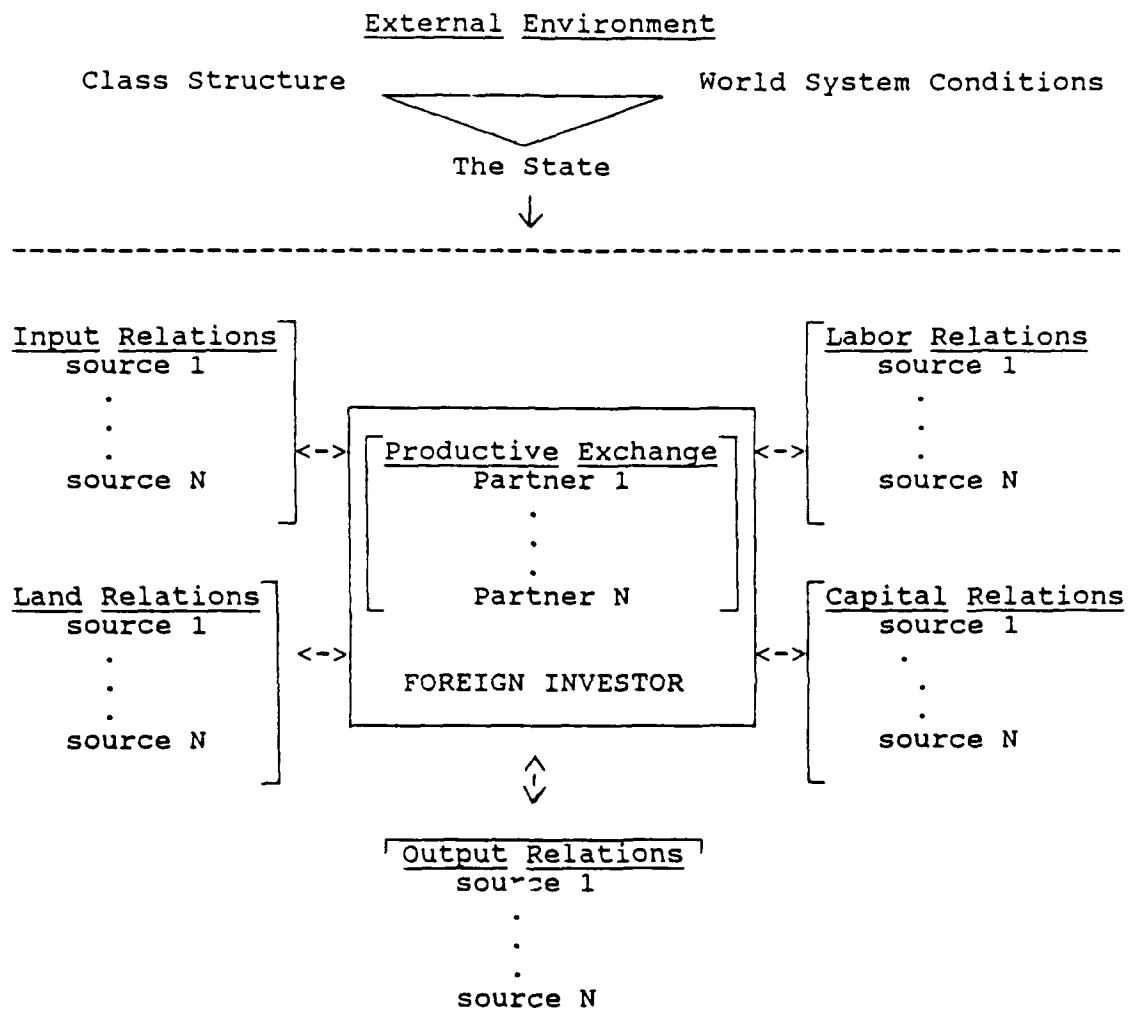
actors are combined to create a new valued product, distinguishing this from simple exchange involving the trading, but not combination of resources" (p.141).

The foreign investor's environment is shown in Fig 2. It is within this framework of relationships that the investor attempts to secure resources. Foreign investors are viewed as actors in a network of exchange relations. The foreign investor's primary goal is to maintain control over resource acquisition. That is, they seek to reduce uncertainty in their environments by employing a number of different strategies. These strategies are aimed at either the exchange relation or the interorganizational network. Those aimed at the exchange relation include coalition formation, network extension, withdrawal, and status-giving. They are intended to affect power differentials in the exchange relation by altering the essentiality of resources or the alternatives to resources. Those aimed at the interorganizational network include cooperative strategies, disruptive strategies, manipulative strategies, and authoritative strategies. Their intended purpose is to affect the flow of resources through interorganizational networks. This former set of strategies is particularly important in the socialist setting. They point to the fact that the external environment, especially the socialist state, heavily

influences resource flow for direct investors. The bottom line is that the actions of investors in China need to be examined in relation to the power differentials in their environments.

FIGURE I

## FOREIGN INVESTMENT ENVIRONMENT: EXCHANGE NETWORK MODEL



### CHAPTER 3

#### THE CHINESE CONTEXT

The People's Republic of China has only recently returned to the world economy after a long period of absence. Following Liberation in 1949, China entered into a period of virtual isolation--an isolation forced upon it by core states. China consequently turned to the Soviet Union and adopted its economic model. The Soviet model proved to be inconsistent with China's goals and was eventually rejected. China, under the leadership of Mao Zedong, was on its own, and the principle of self-reliance guided Mao's China. In the late 1970's, however, changing conditions among the core states and within China itself favored the return of China to the world economy. Taking full advantage of these favorable external and internal conditions, China has adopted an open door policy and embarked upon an era of modernization.

China's withdrawal from the world economy after 1949 was not by choice. Hostilities toward China from capitalist core states, particularly the United States, had forced it out of the world capitalist market (Cho & So, 1988; Chossodovsky, 1986; So, 1987). China had been seen by the U.S. as a bastion of communism in East Asia, and the U.S. policy toward China had become one of isolation

and containment. According to Cho & So (1988), the core states had imposed a trade embargo on Chinese goods, as well as had prevented China from joining the United Nations. China had no other choice but to withdraw from the capitalist world economy.

China turned to the Soviet Union for external support, having been isolated from the capitalist world economy and foreign capitalist investment. The Soviet Union became China's "big brother" despite some fundamental policy differences between the two countries (Cho & So, 1988). China's First Five Year Plan, based on the Soviet Model, focused on heavy industry. It succeeded in achieving a growth rate in excess of 8 percent per year (ORC, 1986).

However, the Soviet model eventually proved to be unacceptable. "The Soviet model favored heavy industries at the expense of light industries and agriculture; cities at the expense of the countryside; and the interests of skilled workers at the expense of unskilled workers and peasants" (Cho & So, 1988, p.7). Such a model was ideologically at odds with the Chinese Communist Party (CCP) policy; the CCP had come to power with the support of the peasants and workers, and had adopted a policy of reliance on the masses. As Cho & So have pointed out,

these fundamental ideological differences manifested themselves as disputes between the CCP and the Soviet Union in the late 1950's, and in the early 1960's, China broke off relations with the Soviet Union. China had become truly isolated from the outside world.

China reacted to its isolation by implementing a model of development based on self-reliance and mass mobilization. However, as the economy grew in size and complexity, the Maoist model became wholly inadequate. China had reached a plateau which mass mobilization could not surpass, and the economy stagnated. Mao's economic policies plunged China into 20 years of economic crisis; a crisis which began with the Great Leap Forward in 1958, intensified during the Great Proletarian Cultural Revolution in the mid to late 1960's, and continued into the 1970's (ORC, 1986). During this time period, China experienced little technological advancement, a low rate of productivity, a very low standard of living, and a lack of consumer goods (So, 1987).

By the late 1970's, economic conditions within China favored its return to the capitalist world-economy, and the core states were more than willing to welcome China back. During the 1970's, the hostilities of core capitalist states toward China had subsided. Previous



attempts to destabilize the socialist regime proved unsuccessful, and the core states, as So (1987) notes, saw an opportunity to exploit the "the split in the Communist camp" (p.3). Moreover, China's return to the capitalist world-economy would be economically advantageous to the core states. China offered a cheap labor force, raw materials, numerous investment opportunities, and most desireably, a huge market for products (Cho & So, 1988).

The internal political scene was also ripe for China's return to the world economy by the late 1970's. Mao Zedong's death in 1976 was a political turning point in China's history (So, 1987). His death marked the changing of the guard: the old revolutionary generation of peasant bureaucrats yielded control to a new generation of career-minded bureaucrats. These new bureaucrats, under the guidance of Deng Xiaoping, support a program of modernization for China and do not adhere to the Maoist idea of mass mobilization (Cho & So, 1988). The Maoist model of self-reliance, egalitarianism, and central planning has consequently been discarded, and China is embarked upon an ambitious program known as the "Four Modernizations".

The Four Modernizations policy was initiated by the Third Plenary Session of the Eleventh Central Committee of

the Chinese Communist Party in December 1978 (Mathur & Chen, 1987). The concept of the Four Modernizations, however, had a much earlier birth. As early as 1964, Zhou Enlai had defined China's primary needs as lying in four areas: agriculture, industry, science and technology, and defense (ORC, 1986). These four areas of development are now contained within both the state and CCP constitutions. The recent economic reforms within China are driven by the Four Modernizations.

The agricultural sector was the first area targeted for economic reforms. The Chinese are addressing agricultural reform with a two-pronged approach (ORC, 1986). They have abandoned the policies of collectivization and communization and are implementing a system of self-responsibility (Cho & So, 1988; Chossoduvsky, 1986; Mathur & Chen, 1987; ORC, 1986). Under this system, a peasant household is responsible for the cultivation of a given plot of land. Each household typically contracts with the state to produce a certain amount of product which the state will purchase at a given price. Any amount produced in excess of the contracted amount is retained by the peasant. The responsibility system is designed to encourage the peasants to work harder

and more efficiently, to cultivate more land, to cultivate cash crops, and to be responsive to market conditions (Cho & So, 1988).

Agricultural reforms are also aimed at developing rural industries. As Chossoduvsky (1986) pointed out, "the modernisation of agricultural production was a means of channeling surplus labour into non-agricultural activities" (p.55). Surplus labor would be used to encourage the development of rural industries, and rural industries, in turn, would provide support for further agricultural modernization.

The industrial sector is undergoing reform measures designed to increase productivity and efficiency. In the past, industrial enterprises had been restricted by a centrally planned economy. Mathur and Chen (1987) argue that such a system fettered initiative, divorced production from consumer needs, and fostered economic inefficiency by not making enterprises responsible for their productivity. Industrial enterprises were "mere appendages of administrative organs" (Mathur & Chen, 1987, 51).

Reformers have responded to the problems of the industrial sector by reducing the role played by central planning in the economy and increasing the role of market

forces (Cho & So, 1988). At the same time, reforms in the managerial system are being implemented (Cho & So, 1988; Mathur & Chen, 1987). Managers are being given greater decision-making powers and are being made responsible for the profits and losses of their enterprise. The state will no longer cover the losses incurred by an enterprise. Furthermore, the staff and workers are entitled to a portion of their enterprise's profits. By implementing these reforms, the reformers hope to encourage the use of scientific management, responsiveness to market forces, economic efficiency, and even entrepreneurship.

The third modernization, science and technology, is important both to the advancement of economic development and to the modernization of China's defenses (ORC, 1986). According to Cho & So (1988), the area of science and technology is being approached through an expansion of scientific, technological, and educational undertakings. These undertakings will increase the number of trained personnel available in China, as well as facilitate indigenous scientific and technological progress.

China's reformers realize that they can not achieve the Four Modernizations on their own. China emerged from the 1950's and 1960's with a dearth of capital, skilled laborers, professional managers, technology, and foreign

exchange (So, 1987). In order to modernize, China must rely on the knowledge and materials of foreign countries and firms. China has consequently adopted an open-door policy and returned to the capitalist world-economy.

While the Chinese recognize the benefits of an open door policy, they are also aware of the dangers inherent in it. China is very conscious of the unequal treatment it had received from foreigners in the past, and thus requires that exchange relationships with foreign countries to be based on a principle of "equality and mutual benefit" (Mathur & Chen, 1987). The Chinese are particularly concerned with the problem of dependency. Dependency has plagued many of the developing countries in Latin America, and China has adopted a number of guidelines to avoid this situation. Mathur & Chen (1987) identified several of these guidelines. First, China still maintains a spirit of self-reliance. The reformers take a cautious attitude toward foreign aid and loans and, if at all possible, prefer not to incur any debts. Developing countries which have made foreign aid and loans the basis of their development have become dependent upon the core states (Dos Santos, 1970). As will be discussed below, China's program of encouraging foreign direct investment helps it avoid the problem of indebtedness.

Another guiding principle in China's modernization program is the idea of appropriate acquisitions. According to Mathur & Chen, China's special needs drive its acquisition of foreign technology, capital, and knowledge. Imports and foreign investment (i.e. joint-ventures) are evaluated in regard to their appropriateness. In contrast, the developing countries which have gone into debt have failed to do the same. As a result, they have not acquired the technology and equipment most appropriate to their own development.

The Chinese reformers also assert their independence from core states by not servicing foreign markets. Dos Santos (1970) argued that dependence was in part caused by an over emphasis on the export sector. The export sector became an important source of foreign exchange, and provided the means by which machinery and raw materials could be purchased for export production. The economies of these dependent countries consequently relied heavily upon exports to overseas markets. "By contrast, while China engages in exports, the focus of its development is not based on production for overseas markets" (Mathur & Chen, 1987, 135). China is instead acquiring technology, capital, and knowledge for its own development. In other words, China is engaging in the production of the means of production (Cardoso, 1972).

The primary means by which Chinese reformers have established relationships with outsiders is through the encouragement of direct investment. The Chinese are encouraging foreign investment in those sectors of the economy which will facilitate their modernization program. Chu Bao Tai (1986), the Deputy Director of the Foreign Investment Administration of the Ministry of Foreign Economic Relations and Trade, identified nine such areas targeted for development during the Seventh Five Year Plan (1986-1990). These areas include: energy development; building materials industry; chemical industry; metallurgical industry; machine-building industry; electronics industry; textile, foodstuff, pharmaceutical, and other light industry; agriculture and aquiculture; and, tourism. This list of target areas is indicative of the types of resources Chinese enterprises will find most valuable.

In order to promote direct investment, the Chinese have set up five Special Economic Zones (SEZ's). The original four SEZ's were established between 1979 and 1980 in Xiamen, Shantou, Shenzhen, and Zhuhai. In 1987, Hainan Island was also designated as an SEZ. The SEZ's purport to offer investors a number of incentives including cheap labor, cheap land, tax holidays and low tax rates, free import/export duties, and good infrastructure (So, 1987).

The establishment of the special economic zones was followed in 1984 by the formation of "development zones" in 14 coastal city-ports. These development zones allow transnational capital to set up subsidiaries and "invest entirely along capitalist lines" (Chossudovsky, 1986, p. 132). Additionally, reforms at the institutional level have increasingly enabled individual Chinese enterprises to enter into joint-ventures and other economic endeavors without government approval.

China has specifically encouraged the establishment of Sino-foreign joint ventures, Sino-foreign cooperative enterprises, and wholly-owned foreign enterprises. Of these three forms of direct investment, equity joint ventures and cooperative enterprises (also known as contractual joint ventures) are the most common in China today (see Table 1). By 1986, equity joint ventures accounted for 41% of the total number of foreign investment projects in China and 20% of their total contracted value while cooperative joint ventures accounted for 56% of the total number of projects and 49% of their total contracted value.



TABLE I

## TOTAL FOREIGN INVESTMENT IN CHINA

## Number of Projects 1979-1986

Equity joint ventures	3,213
Contractual joint ventures	4,383
Offshore oil	41
Wholly foreign-owned	138
Total	7,775

## Contracted Value 1979-1985

(millions \$)

Equity joint ventures	3,411.68
Contractual joint venture	8,210.09
Offshore oil	2,782.50
Wholly foreign-owned enterprise	516.99
Compensation trade	1,253.72
Other	485.73
Total	16,660.71

Note: Data taken from China Business Review, 3, 1987, p.33.

Although equity and contractual joint ventures are covered under the same law, they differ in several respects. The equity joint venture involves a stricter application of the 1979 PRC Law on Joint Ventures. Its distinctive features include:

1. The joint venture is financed and run by the joint venturers who share the risks and profits.
2. The foreign partner must own at least 25% of the joint venture.
3. The joint venture's shares are calculated in a single kind of currency in spite of the diverse form of investment. The joint venturers share the responsibilities as well as the rights and interests commensurate with their respective contributions.
4. Since the joint venture is a limited liability company, its liabilities are limited to its total assets. The liabilities of each joint venturer are limited to its share of the registered capital, and nobody is accountable for indebtedness of anybody else.
5. The joint venture must be located within Chinese territory, approved by the Chinese Government, and registered with the department in charge of industry and commerce before it acquires the status of a legal person, and must pay according to Chinese tax laws.

6. The joint venture has full right to independent operation and the right to handle directly its imports and exports. (Chu, 1986, p.18)

The cooperative enterprise (or contractual joint venture), on the other hand, is set up under a flexible application of the joint venture law. This type of arrangement typically involves an "export processing contract with a state enterprise, a licensing agreement, compensation trade with buy-back provisions, and so on" (Chossudovsky, 1986, p.151). The rights and obligations of each partner, including the distribution of profits and losses, are set forth in the contract. The Chinese and Foreign investors may act as a single legal person, or as two separate legal individuals. As Chossudovsky noted, the joint venture law is "significantly" ambiguous. For the most part, joint venture arrangements are left to the discretion of those involved, and wholly foreign-owned enterprises are not prohibited.

In sum, China has recently returned to the capitalist world economy after a long period of absence. The capitalist core states which had once isolated China from the world economy have now welcomed it back. Over the past decade, China has been engaged in an intensive program of modernization in order to catch up with the rest of the

world. China, however, lacks many of the resources it needs to properly carry out modernization, including advanced technologies and managerial know-how. The Chinese have consequently shed their self-reliant attitude and now look to the outside for the resources they lack. Foreigners have been invited to enter into exchange relationships with the Chinese on a basis of "equality and mutual benefit."

A major component of the Chinese strategy has been to encourage foreign direct investment in the forms of equity and contractual joint ventures, and wholly foreign-owned enterprises. However, according to the US Embassy in China, the Chinese have set up "an investment environment which no one, except the Chinese, has yet characterized as attractive" (Sterba, 1986a). In 1986, the initial excitement over China's open door policy gave way to the stark reality of its investment environment. Foreign investors have complained of high costs, arbitrary taxes, inadequate labor, a restricted domestic market, and other problems. Although no large firms have pulled out, new investors are staying away. Official statistics show that the contracted foreign investment in 1986 fell to \$2.9 billion from \$5.85 billion the previous year and actual investment dropped to \$1.5 billion from \$1.57 billion

("Peking Admits", 1987). In the following chapters of this paper, we'll use our exchange network model to examine the problems investors have encountered in China.

## CHAPTER 4

### METHODOLOGY

This study of foreign direct investment in China was based on qualitative research. The research was conducted using two methods: journal research and semi-structured interviews.

The journal research consisted of a review of four publications: the Asian Wall Street Journal, the Chinese Business Review, the Far Eastern Economic Review, and the Beijing Review. These publications were chosen because of their coverage of economic issues in China and the Asian region. Other journals are available which cover the same topic area, but for reasons of parsimony only these four publications were reviewed.

Issues from these four publications covering a two year period from 1986 to 1987 were reviewed. The rationale behind researching these two years is several fold. First, 1986 was the year in which foreign investors faced the sobering reality of China's investment environment. Numerous problems related to foreign investment were brought to the attention of Chinese government officials and the world in general in that year. The souring of the investment atmosphere was marked by a 42% decline in the

contracted value of investment in the first nine months of 1986 as compared to the previous year (Sullivan, 1987). Moreover, China implemented its Seventh Five Year Plan in 1986 and attempted to address the concerns of its investors. A review of publications from the years 1986 and 1987 should provide a good picture of the current state of direct investment in China while allowing for an evaluation of strategies used by investors.

The second portion of the research was carried out in New Zealand. This portion of the research consisted of semi-structured interviews with five persons, all of whom had first-hand knowledge of or were actually involved in direct investment in China. The interviewees came from both the government and private sectors of New Zealand. They included:

- 1) An official from a division of the New Zealand Ministry of Trade and Industry dealing exclusively with N.Z.-China relations.
- 2) An official from a division of the New Zealand Ministry of Foreign Affairs dealing with the North Asia region.
- 3) An official from an organization set up by private business persons in order to facilitate N.Z.-China business relations.

4) An executive from a New Zealand multinational involved in the production of foodstuffs and animal feeds. The multinational, which will be referred to as NZ FOODCO for confidentiality sake, is involved in a joint venture in China which produces animal feed premixes and concentrates.

5) An executive from a New Zealand company involved in the production of computer systems. The company, which will be referred to as NZ TECHCO for confidentiality sake, has a wholly foreign-owned subsidiary in China.

The interview schedule was structured after the exchange network model of foreign direct investment presented previously in this paper. The interview schedule focused on each of the six primary relationships of the foreign investor: the joint venture partnership, capital relations (including foreign exchange), input relations, labor relations, land relations, and output relations. Within each of these areas, information was sought as to the number of alternative sources available in the relationship, the essentiality of the relationship, restrictions placed on the relationship (including infrastructural restrictions), and the strategies used by foreign investors in the relationship. Particular



attention was paid to the role of governments, private organizations, and expatriate Chinese in the relationships. The actual interview schedule is shown in Appendix A.

The New Zealand government provided the names and contact addresses of those persons who were interviewed. These persons were subsequently contacted by mail or telephone, and interviews were arranged. The interviews took place at each individual's office, except for one interview which was conducted by telephone. Each interviewee was asked to provide any general or specific information they could on each of the six areas of the interview schedule. Because of the differing backgrounds and unique perspectives of each of the subjects, not every area was equally applicable to each of their cases. Nonetheless, they were asked to provide what information they could. Detailed fieldnotes were kept for each of the interviews. Approximately ten hours of interviews were completed.

## CHAPTER 5

### RESULTS AND DISCUSSION

In this chapter, direct investment will be analyzed from an exchange network perspective. However, before continuing with our discussion, a brief summary of the exchange network model should prove to be beneficial. According to our exchange network model, the foreign investor's environment is characterized by five sets of simple exchange relations--capital, input, labor, land, and output. These simple exchange relations are based on the transfer of resources between two or more organizations for mutual benefit. Furthermore, if a joint venture is involved, a productive exchange relationship exists between joint venturers.

The balance of power in each of these relationships is a reflection of the dependency of one organization on another (e.g. the power of actor A over B equals the dependency of actor B on A, and vice-versa). Dependency is based upon the number of alternative sources available for a particular resource, and the essentiality of that resource to an organization. Power is also a reflection of an organization's ability (or inability) to affect the flow of resources in their exchange relationships or networks. This category of power is based upon the organization's

position in a network and the influence of the external environment. In order to secure necessary resources, organizations utilize power balancing processes and interorganizational strategies in relation to the power differentials which exist in their exchange relations and networks.

The results of our qualitative research will be discussed in reference to each of the foreign investor's six primary relationships--productive exchange (if a joint venture is involved), capital, input, labor, land, and output. Our analysis of each of these six relationships will focus on (1) the nature of the exchange relationship, (2) the power differentials resulting from the exchange relationship and the interorganizational network, and (3) the strategies used by investors in relation to these power differentials. It is hoped that the exchange network model proposed in this paper can shed light on the process by which individual foreign investors attempt to establish themselves in a socialist country, and help identify the barriers they face.

## Productive Exchange Relations

### The Exchange Relation

The most prevalent form of foreign direct investment in China today is the Sino-Foreign joint venture. Our first task is to analyze the basis upon which these relationships are formed. A joint venture, whether equity or contractual, is characterized by a productive exchange relationship between a foreign firm and one or more others. organizations will enter into productive exchange relationships with those partners who can best aid them in creating a "new valued product." In other words, foreign investors will seek out Chinese partners who can provide certain valued resources, and vice-versa. Resource requirements are dictated by each organization's specific functions (Levine and White, 1961). Productive exchange relations, like simple exchange relations, exists as long as both parties are benefiting from it.

Several general categories of valued resources can be identified for both Chinese organizations and their foreign counterparts. The resources sought by the Chinese are for the most part prescribed by state policy. The Chinese seek to attract foreign firms which: 1) can provide technology and capital in the areas of agriculture, light

industry, and heavy industry; 2) can help update its infrastructure including its transportation system, its harbors, and its communications system; 3) can promote China's extractive and energy resource capabilities; 4) can provide foreign exchange for China; 5) and, can provide employment for its people (Mathur and Chen, 1987). Furthermore, China wishes to attract these resources without sacrificing its economic, political, or cultural sovereignty. Specific organizational resource requirements will be guided by these broad objectives.

The resources sought by foreign companies in China would include labor, land, raw materials, and markets. According to Chossoduvsky (1986), transnationals will enter joint venture agreements for essentially two reasons: to penetrate the Chinese market, and to produce, process or assemble products for export markets using China's abundant cheap labor. The Sino-Foreign joint venture typically involves a relationship in which the Chinese side provides land, labor, and raw materials while the foreign side provides technology, equipment, foreign exchange, and managerial know-how. The exact nature of each relationships varies from joint venture to joint venture.

NZ FOODCO, for example, has entered into a productive exchange relationship with a Chinese enterprise

and another foreign corporation. This three-way partnership took the form of an equity joint venture which produces animal feed premixes and concentrates in the People's Republic of China. The foreign partners have contributed 50% of the total investment with the remainder being contributed by the Chinese side. Contributions from NZ FOODCO and the other foreign partner have included financing for the milling factory, and technical and managerial expertise. The Chinese side has provided the land and operating finances. Resources are combined, rather than traded, in this relationship in order to produce a valued product, i.e. the animal feed premixes and concentrates.

The production of premixes and concentrates is not the sole reason for NZ FOODCO's involvement in the joint venture. NZ FOODCO has ulterior motives for establishing the joint venture in China. Knowledge of the Chinese business environment and the acquisition of a foothold in that environment are equally, if not more, important to NZ FOODCO than the actual production of animal feed premixes and concentrates. The corporation is operating in China under the assumption that China will be an economic force to be reckoned with in the future. In one sense, the relationship between the New Zealand and Chinese partners can also be seen as a simple exchange relation (i.e. one

based on trade); NZ FOODCO provides finance and expertise in exchange for knowledge of China's business environment.

### Power Differentials

The exchange network model specifies a need to study the power differentials which exist in an exchange relationship. According to our model, the power of one organization in a relationship is equivalent to the dependency of the other one on it. Dependency, in turn, is reflective of the number of alternative sources available to an organization, and the essentiality of the resource in question to that organization's operations. Two questions must be answered in our analysis of joint venture relationships: what power does the Chinese partner hold (or how dependent is the foreign partner on the Chinese partner); and conversely, what power does the foreign partner hold (or how dependent is the Chinese partner on the foreign partner). We'll address the former question first.

The number of potential partners available to foreign investors is quite large. Internationally, other Asian and South East Asian countries compete with China to attract foreign capital. In fact, Third World countries in general offer competitive environments to multinationals.

Competition for foreign capital also exists within China. China has already established five Special Economic Zones and fourteen coastal development zones dedicated to attracting investment. Moreover, China's hinterland is opening to foreign investment. Almost all of China's 29 provinces, municipalities, autonomous regions have set up Foreign Economic Relations Commissions in order to facilitate direct investment (Haitao, 1986). Because foreign investors have access to a number of potential partners outside of China as well as within, they are not dependent upon Chinese enterprises. Consequently, the Chinese partners exercise little power over their foreign partners in joint venture relationships.

For example, the Chinese partner in NZ FOODCO's joint venture exercises little power over the New Zealand multinational due to the fact that the multinational has a wide range of potential partners available to it. NZ FOODCO has a tradition of overseas investments, including joint ventures. They have been or are currently involved in projects in such locations as Western Samoa, Fiji, New Caledonia, Malaysia, Sri Lanka, and China. Within China itself, NZ FOODCO was approached by upwards of five perspective partners from across the country. Moreover, NZ FOODCO's interest in the Chinese joint venture is not exceedingly great. The joint venture is a relatively small



investment for the large New Zealand multinational, and although it is important in its own right, the joint venture is not essential to the operation of NZ FOODCO.

The second question posed in this section, i.e. what power does the foreign partner hold in a joint venture, is a bit more difficult answer. However, it appears as though the foreign partner exercises considerable power. First, foreign investors offer a number of resources essential to China's modernization program. China's open door policy was implemented in order to attract these valued resources. Second, Chinese enterprises appear to have limited alternatives when it comes to choosing partners. The numerous concessions offered to foreign investors by different Chinese provinces and municipalities is indicative of the intense competition that exists within China. The combination of limited alternatives and a desire for foreign resources makes the Chinese enterprises dependent upon foreign firms, thus giving the foreign investor a position of power.

In the above discussion, power was analyzed within the context of the joint venture relationship per se. It is apparent that the balance of power in these relationships favors the foreign investor. Power must also be examined within the context of the interorganizational

network. This type of power is based on an organization's ability to affect the flow of resources within a network. Power differentials in the interorganizational network are a reflection of an organization's position in the network and its linkages with the external environment. Moreover, the external environment can condition exchange networks and relationships in such a way as to limit the organization's control over them.

In socialism, the state plays a crucial and determining role in exchange networks. The formation of a joint venture partnership, for example, is by no means an isolated process. On the contrary, the relationship, at least in its formative stage, is highly conditioned by the Chinese State. It is characterized by a multi-stage approval process and the participation of numerous government agencies. (The May-June 1986 issue of China Business Review lists 18 government agencies directly or indirectly involved with the approval process). Each step in the approval process presents another opportunity for outside interference. Because it is ultimately dependent upon approval from outside organizations, the exact nature of the relationship between joint venturers may be altered by their environment.

Although the approval process for foreign investment projects varies slightly from project to project, a more or less general set of procedures can be identified (Lee & Ness, 1986; Haitao, 1987). The first step in the approval process requires that a project proposal and/or preliminary feasibility study (depending upon the project) be submitted to the appropriate government department. These documents are subject to approval by the Local Planning Commission (LPC) or the State Planning Commission (SPC) if the project exceeds local approval authority. Furthermore, the Ministry of Foreign Economic Relations and Trade (MOFERT) has the authority to review all proposals to ensure compliance with state regulations. This first step is largely the responsibility of the Chinese partner, although the foreign partner (if known) can become tangentially involved.

In the next step, a formal feasibility study must be submitted. This submission is a joint effort by the Chinese and foreign partners. It covers all aspects of the proposed project, from the acquisition of raw materials to projected operating expenses. In most locations, the LPC has the authority to approve joint feasibility studies in consultation with the local Foreign Economic Relations and Trade Commission (FERTC). MOFERT retains the authority to review all such studies; its main purpose in reviewing

joint feasibility studies is to ensure that joint ventures can maintain a positive foreign exchange balance.

A prospective joint venture's final hurdle is to obtain approval of the project itself and register at the local administration for industry and commerce. A large number of documents must be submitted to MOFERT or the local FERTC (if the project is within local approval authority) for final project approval. MOFERT or the local FERTC are responsible for coordinating review of the project documents by all relevant agencies. Final approval can be granted after this review is complete. If and when approval is granted and registration is completed, the joint venture must for a business license.

The State's ability (i.e. power) to condition authoritatively the productive exchange relations of foreign investors is quite a daunting prospect for many foreign business persons. The cumbersome approval process often times inhibits the formation of joint venture partnerships, and can disillusion even the most stubborn foreign investor. The problems most frequently cited by the journals and interviewees in regard to interorganizational networks have their origins in the Chinese bureaucracy. These problems can be divided into two categories: those caused by the sheer size and

inefficiency of the bureaucracy, and those resulting from infighting between competing departments and ministries. In reference to the former set of problems, Haitao (1987) pointed out that foreign investors are baffled by the myriad of Chinese officials and departments they must talk to and are unsure who has final say. As a result, the approval process can be dragged out for a period of years.

This problem is compounded by the fact that policies and rules are often contradicted by different agencies. This observation was supported by members of New Zealand's private and government sectors. For example, the official from New Zealand's private association of business persons discovered that if Chinese officials from different localities and agencies were asked a standard set of questions, their answers were often times inconsistent and even contradictory. In fact, policies are not necessarily consistent across different levels of the same hierarchy.

The second problem encountered by foreign investors derives from the fact that China is decentralizing its bureaucracy. Grow (1987) reported that infighting among economic agencies and ministries was becoming more common as a result of the decentralization. In addition to aggravating the problem of inconsistent policies described above, decentralization has created a situation whereby

projects from one office may interfere with the plans of another. This unfortunate situation can create considerable obstacles for the foreign investor.

SPD Medical Technologies, a US firm, was one victim of such infighting (Grow, 1979). In 1985, SPD was approached by China pharmaceuticals with a proposal to form a joint venture. Both companies had been hurt by changes in the Chinese budget process the early 1980's. SPD's contract with the Ministry of Public Health had been cancelled, and China pharmaceuticals had lost some of its major customers. The joint venture appeared to be a solution to both their problems; it would allow the two companies to regain their lost markets. After a short period of time, SPD Medical Technologies and China pharmaceuticals negotiated a mutually acceptable agreement.

The prospective joint venture's problems started after the agreement was negotiated. "Several outside agencies viewed the contract as a potential threat to their own plans" and "actively attempted to side track the new joint venture or at least put it on hold" (Grow, 1987, p. 42). More specifically, an official from the State pharmaceutical Administration (SPA) feared that the prospective project might hurt his plans to develop several large scale drug production and packaging projects in

different parts of China. The official therefore decided to interfere with the approval of SPD's joint venture.

The SPA is a very influential agency in China. In accordance with our exchange network model, SPA derives its power from essentially two sources: its position in the Chinese medical supply network (SPA is a major source of foreign drugs and equipment for the hospital associations in China), and its contacts with other government agencies. The SPA used this power to manipulate the prospective joint venture's environment in two specific ways. First, the SPA used its power of position to caution hospital associations against signing purchase agreements with the prospective joint venture. Without these potential customers, the joint venture would not be able to output its products and generate income. Second, the SPA engaged in a manipulative strategy whereby it used its contacts with other government agencies. SPA's objections to the project prompted several other state agencies to make their own inquiries. These inquiries served to prolong the approval process for the SPD-China pharmaceutical joint venture.

In China, an investor's power in interorganizational networks is largely dependent upon whether or not they have contacts with government officials. Contacts can be fostered directly with

bureaucratic officials, or indirectly through expatriate Chinese. An investor's power in interorganizational networks enables it to engage in a number of different strategies which affect the flow of resources. The SPD-China pharmaceutical case demonstrated the importance of power in interorganizational networks. Because SPA possessed such power, it was capable of inhibiting the formation of the joint venture. SPD and China pharmaceuticals, on the other hand, did not possess any power relative to their networks. Consequently, they were not able to use any strategies to overcome their problems. In the next section, we will review the strategies available to foreign investors in their joint venture relationships and networks.

### Strategies

The concept of power is important to our understanding of the activities and strategies used by organizations. According to the exchange network model, power differentials are based on both the exchange relationship itself and the interorganizational network. The strategies used by companies must therefore be examined in relation to these two power bases.



It was apparent from our previous discussion that the balance of power favored the foreign investors within joint venture relationships. Salem (1987) reported that foreign investors are taking advantage of this power imbalance. Specifically, a pattern is emerging among potential foreign partners whereby they threaten to withdraw from negotiations or even abandon an operation if the Chinese side does not live up to the major elements of the contract. Withdrawal, if you will recall, is one of the four power balancing strategies identified by the exchange network model. In this case, investors are using the withdrawal strategy to create a greater imbalance of power in their relationships and thus strengthen their bargaining position.

Whereas foreign investors operate from a position of power in their joint venture relationships, the same is not true when we consider the network in which these relationships are embedded. Problems arise for foreign investors because the Chinese government is in a position of power and can condition joint venture relationships. The government interferes in these relationships by way of an extensive approval process. Faced with these network restrictions, foreign investors typically resort to using a manipulative strategy. That is, they use their political contacts to smooth the approval process. According to

Cohen and Cheng (1987), the trump of many foreign investors who have received official relief have been highly placed relatives or other connections. Political support is crucial to establishing and running a joint venture in China (Leung, 1986). These manipulative strategies have been useful to investors in practically all aspects of doing business in China.

### Capital Relations

Effective capital relations are critical to the existence of any enterprise. In this section, we will examine the capital relationships of foreign investors in China. The emphasis is on financial, rather than physical, capital. Our discussion will focus on two areas in particular: the Chinese foreign exchange quandary, and financing through loans.

#### Foreign Exchange--The Exchange Relation

In foreign exchange relations, foreign investors exchange either their products or their local currency (which is the nonconvertible renminbi or RMB) for the foreign currency of other organizations. Although all foreign exchange relations are based on the concept of simple exchange, their exact nature can vary quite a bit.

Seven basic categories of foreign exchange relations can be identified (Gelatt, 1986; Beijing Review, 1986). The categories are listed below and should give the reader an idea of what types of resources are exchanged in these relations:

- 1) Export. Companies can generate foreign exchange by exporting all or part of their products overseas. The Chinese state highly encourages this practice among enterprises.
- 2) Import substitution for high technology and other essential products. The Chinese government has agreed to resolve foreign exchange deficits for companies producing high technology and other essential products for the domestic market (i.e. the government will trade foreign exchange for renminbi--the domestic currency which is nonconvertible).
- 3) General import substitution. Companies whose products are officially designated as import substitutes may sell their products to domestic companies in exchange for foreign currency.
- 4) Non-import substitute domestic sales. Ventures not engaged in import substitution may also sell to the domestic market in exchange for foreign currency.
- 5) Countertrade. Foreign enterprises may purchase Chinese products with their renminbi profits and resell

the products on the international market. This strategy utilizes the foreign partners overseas connections. NZ FOODCO, for example, exports a portion of its Chinese joint venture's animal feed premixes and concentrates to another of its overseas joint ventures where it is further refined and sold for foreign exchange.

6) Currency Trading. Foreign investors with two or more joint ventures may use surplus foreign exchange from one to balance the deficit in another given that all parties agree to the currency trading. NZ TECHCO, which has set up a wholly foreign-owned operation in China, balances its foreign exchange by trading currency with a network of other companies.

7) Reinvesting RMB. Foreign investors may also reinvest their RMB profits in a Chinese enterprise which is capable of generating foreign exchange. The investor is then entitled to a portion of the foreign exchange profits of that enterprise. International Hydron, which produces contact lenses for the Chinese domestic market, plans to repatriate profits by reinvesting in a wholly foreign-owned joint venture which makes items for export (China Business Review, 1986).

## Foreign Exchange--Power

As in our analysis of power in joint venture relationships, we must ask ourselves two standard questions: what power does the foreign investor hold in the foreign exchange relation, and what power does the investor's exchange partner hold in the foreign exchange relation. Let us begin by analyzing the power of the foreign investor's exchange partner. In other words, we will attempt to assess the foreign investor's dependency on the exchange relation.

From the foreign investor's point of view, foreign exchange is a highly essential resource. It is necessary for the procurement of foreign materials and for the repatriation of profits overseas because China's domestic currency, the renminbi (RMB), is non-convertible. With regard to alternative sources, foreign investors apparently have numerous ways in which to generate foreign exchange (see the options listed above). In reality, however, these options are not always viable for two reasons: few organizations are willing to trade their foreign exchange for the types of resources offered by foreign investors, and the State has imposed a number of restrictions on these options. Consequently, since foreign exchange is a highly essential resource and since few alternative sources exist,

foreign investors find themselves in a position of dependency.

In considering the reverse situation--the exchange partner's dependency on the foreign investor--we find that the exchange partner generally does not consider the resources offered by the investor (i.e. locally produced goods and renminbi) to be essential. In fact, the non-essential nature of these resources is one of the factors which limits the investor's foreign exchange options. For example, Gelatt (1986) noted that the Chinese have a customary preference for products from abroad, even if the China based joint venture can produce an identical product at a lower price. Thus, import substitution becomes less viable. Similarly, the undesireability of the RMB makes countertrade, currency trading, and reinvestment questionable options. In countertrade, there is little incentive for Chinese enterprises to sell their export worthy products for RMB when they could be earning foreign exchange by exporting the product themselves. It is also doubtful that a Chinese partner to a joint venture would be interested in trading its joint venture's foreign exchange for RMB, just as it is doubtful that a Chinese enterprise which is capable of generating foreign exchange would be interested in sharing a portion of its earnings with an investor in return for an RMB investment (Gelatt, 1986).

Moreover, organizations that possess foreign exchange have little trouble finding other organizations which are willing to trade away their RMB. It is hard to say whether the same holds true for organizations that are trading foreign exchange for import substitutes or other locally produced goods. This issue is best examined on a case by case basis. Nonetheless, judging from the generally non-essential nature of the foreign investor's resources and the potential number of trading options available to the exchange partner, the exchange partner does not appear to be dependent upon the foreign investor. The overall power balance in foreign exchange relations consequently favors the possessor of foreign exchange and not the investor.

On an interorganizational level, foreign exchange relations are subject to a considerable amount of outside interference which limits the power of foreign investors in their exchange networks and bolsters the power of the Chinese State. The 1986 Provisions which established most of the foreign exchange options require that certain procedures be followed when implementing them. In most cases, approval must be granted by specific government agencies. For example, companies planning to engage in import substitution must gain approval from relevant

central or local authorities, and those planning to sell non-import substitute products on the local market for foreign currency must gain approval from the foreign exchange control authorities. It is very likely that investors will encounter bureaucratic delays and infighting in these relationships.

#### Foreign Exchange--Strategies

By far, the most vexing problem for foreign investors in China today is generating foreign exchange. The problems encountered by investors can be traced back to the unfavorable power differentials which exist in their foreign exchange relations and network. However, manipulating resource flow through the use of high level contacts is one interorganizational strategy used by foreign investors to ensure a continual flow of foreign exchange, as the American Motor Corporation (AMC) can attest to.

In 1986, the AMC-Beijing joint venture experienced a much publicized shortage of foreign exchange (Schiffman, 1986; "Problems," 1986). The shortage was severe enough to force a shut down in the joint venture's production of jeeps. Problems for the joint venture began after it lost its primary buyer, the government, because of new



restrictions on the use of foreign exchange promulgated by central authorities. Without this source of foreign exchange, the AMC-Beijing joint venture was not able to purchase kits for its Cherokee jeeps or finance the retooling of its factory. The retooling would have allowed the Chinese to produce jeep parts themselves ("China Promises," 1986).

The AMC project had been heralded as the flagship of China's open door policy before it ran into problems in June 1986. Because of its much touted position, AMC's problems became the focus of national attention. Schiffman (1986) viewed AMC's case as a test case for other foreign investors; a gauge by which they could judge China's investment atmosphere. When AMC allowed its grievances to become public, Chinese officials took note. "The gesture aroused enough high level concern in China to guarantee the venture renewed foreign exchange for kit purchases" ("Problems," 1986). In other words, AMC had utilized its linkages with the state in order to manipulate the flow of foreign exchange; AMC's flagship status had ensured it official support.

The AMC-Beijing joint venture also began selling Cherokee jeeps to foreigners in China in exchange for foreign currency. According to our exchange network model,

this strategy is known as network extension. It serves to reduce the dependency of an organization on any single exchange partner. In other words, by accessing an alternative source of foreign exchange, the AMC-Beijing joint venture reduced its dependency on the government, and thus reduced the power of the government in the exchange relation.

#### Loans--The Exchange Relation

Bank loans makeup a large portion of the financing for Sino-Foreign joint ventures. Haitao (1987) reported that an analysis of the accounts of 400 such projects showed the registered capital of all of them to be lower than the amount of their bank loans. Loans are based on the exchange of RMB or foreign currency on behalf of the bank for a promise of repayment in kind plus interest on behalf of the foreign investor.

#### Loans--Power Differentials

The dependency of foreign investors on banks derives from the essentiality of the banks' resources to the investor, and the number of banks available to them. Banks provide financial capital to foreign investors--a resource which is critical to their operations. Since

financial capital is obviously essential, the question of dependency turns on the issue of alternative sources of financial capital. In the previous paragraph, we saw that bank loans make up a large portion of joint venture accounts. Although these joint ventures have access to both domestic and overseas banks, most of them appear to have obtained loans from one bank in particular, the Bank of China. In fact, all joint ventures are required to open foreign exchange accounts with the Bank of China or other banks acceptable to it. This apparent lack of banking alternatives combined with the highly essential nature of financial capital puts foreign investors in a position of dependency.

In the reverse situation, we can assume that the resource provided by foreign investors, i.e. repayment in kind plus interest, is essential to the operations of banks. The question of dependency once again turns on the issue of alternatives. If we focus our attention on the Bank of China, there appears to be quite a few organizations seeking loans from it. Thus, the Bank of China is not overly dependent on any single customer, and the overall balance of power between foreign investors and the Bank of China favors the latter.

The Bank of China is a powerful actor in the investment environment because of its important and apparently exclusive role in financing Sino-Foreign joint ventures. Consequently, the Bank is capable of implementing and enforcing stringent requirements for loans. Foreign investors and their Chinese partners are unable to secure loans from the Bank of China unless they meet these requirements, including having a sound credit standing and a promising future. The terms tend to favor advanced technology and export enterprises while placing agricultural projects at a disadvantage. The latter category of projects is subject to the unpredictable effects of the weather. Moreover, loans are often times contingent upon a joint venture's ability to obtain foreign exchange guarantees for the loan. Provisions promulgated by the Bank of China in February 1987 placed tighter restrictions on which organizations are allowed to make guarantees and the limits of those guarantees. As a result, foreign enterprises could find it more difficult to borrow funds.

Tianlong Knitwear Enterprise was one joint venture that failed to meet the stringent requirements of the Bank of China (Haitao, 1987). The Hong Kong-Hubei province joint venture fell short on two accounts. First, it did not possess enough registered capital to qualify them for

the loan desired. Second, the companies financial record was not up to standards; the company had sustained a 1.14 million yuan loss by the end of June 1987. Tianlong Knitwear's case is not unique. The Shanghai-Bell Telephone Equipment Manufacturing Company suffered the same fate despite its classification as an advanced technology enterprise eligible for special treatment.

#### Loans--Strategies

Judging from our research, investors have not been able to incorporate any effective power balancing or interorganizational strategies against the Bank of China's stronghold other than perhaps extending their networks, i.e. seeking financial capital from overseas banks and other similar sources. However, it is hard to make an accurate judgement on the effectiveness of other strategies since problems of obtaining loans do not appear to be too pressing. They have not received nearly as much attention as the problems surrounding foreign exchange. (Loans, of course, are also a source of foreign exchange for foreign investors, but they do not involve the "generation" of currency in the same sense as was discussed previously).

## Input Relations

### The Exchange Relation

Effective financial relations allow enterprises to purchase the inputs necessary for production, as was demonstrated in the AMC case. Input requirements cover a wide range of items from raw materials to spare parts to power. Requirements vary between one organization and the next depending upon each organization's specific functions. These relations are usually based on an exchange of money for input materials. renminbi is typically used to purchase inputs from the domestic market, and foreign exchange is used for purchases from overseas markets.

### Power Differentials

Power differentials (or dependencies) in the input relationships themselves are best studied on a case by case basis since input requirements vary between organizations and so do the sources of those inputs. Because of this, we will attempt to make only a few general observations about the number of alternative sources available for resources. Most of our attention will be focused on power differentials in the input networks. With regard to alternatives, foreign invested firms can potentially

purchase inputs from both the domestic and international markets. Some enterprises are capable of fulfilling a large portion of their input requirements by making use of local suppliers; others are not and must turn to outside sources. In general, China appears to have an abundance of raw materials, but is lacking refined inputs such as construction materials, machine parts, and high technology items. These inputs are either simply not available in China or are of substandard low quality. Consequently, investors seeking these items for their enterprises are limited to overseas sources which are often times more costly and require the expenditure of valueable foreign exchange.

For example, a top US design and construction company, CRS Sirrine, encountered problems in its input relations while constructing the Heinz UFE Infant Food Factory in Guangzhou (King, 1987). CRSS's strategy depended upon the availability of construction materials. Unfortunately, the State allocation system was not able to supply the basic construction materials (such as concrete and reinforcing bar) needed for the factory. There was also a shortage of rebar on China's open market. As a result, CRSS was forced to procure construction materials from sources outside of China. A total of \$3.9 million in equipment and materials were purchased from 139 vendors in

equipment and materials were purchased from 139 vendors in the United States, Western Europe, and Hong Kong. Moreover, CRSS had to use the foreign exchange portion of its payments to purchase these materials.

The State exercises considerable power over input networks. For those foreign investors who chose to purchase at least part of their inputs from local sources in China, they most likely will have to deal with the State allocation system. China has set up a system of bureaus and agencies which sell input materials to business enterprises including Sino-Foreign joint ventures and wholly foreign-owned enterprises. By doing this, the government has authoritatively structured the investor's domestic environment (i.e. the number of alternative sources) and limited their power in both their individual input relationships and their overall input exchange networks.

(Fortunately for the foreign investor, these various bureaus and agencies in the allocation system are not unified; investors would have little power against a monolithic allocation system. It appears as though decentralization is slowly diminishing the power of the State. The NZ FOODCO executive remarked that intercity as well as interbureau rivalries exist, thus creating a



competitive atmosphere among State suppliers. NZ FOODCO purchases a large portion of its inputs such as feeds, drugs, chemicals, and some spare parts from State agencies. The NZ FOODCO executive warned that exploiting the competition in China's allocation system could close doors for the foreign investor if the wrong person in the wrong agency becomes upset, particularly when that person has family ties to other organizations.)

Moreover, the Chinese State can make use of numerous import controls which can further limit power of investors relative to their interorganizational network. For example, NZ TECHCO had concluded sales agreements with several Chinese companies for computer systems. Delivery of the computer systems was delayed because of import controls; the Chinese companies were having trouble obtaining import licenses for the equipment. It took one company seven months and three visits by provincial officials to the central government before approval was granted. The major problem in obtaining the import licenses was bureaucratic; no one would explicitly say "yes" or "no" to the request. Import licensing has posed similar problems for NZ FOODCO. In their case, import licensing problems have held up the acquisition of some spare parts.

The China Business Review ("Imports," 1987) reported that protectionism flourishes in China because local authorities are able to implement import controls without State approval, and because the Chinese believe they must protect their fledgling industries from outside competition. In fact, bureaucrats are often rewarded for interrupting certain trades. The Review noted two broad categories of controls used by the Chinese: administrative and market. The former category includes the formulation and implementation of import plans; foreign trade enterprise licensing; import commodity licensing; foreign exchange controls; import contract supervision and approval; and inspection of product specifications and standards. The latter category of controls, which supplement rather than replace the administrative controls, includes exchange rate manipulation; custom tariffs; industrial and commercial taxes; and import regulatory taxes.

Import controls are not the only restrictions on these interorganizational networks. The inadequacy of China's transportation infrastructure also restricts many of the input relations. NZ FOODCO, for instance, has found that transportation problems inhibit the procurement of spare parts. Spare parts are delayed or even lost in

transit. Furthermore, the facilities for tracking down lost shipments are primitive. The blame for fouled up shipments is shifted from one agency to another, and it becomes practically impossible to discover where, why, and how shipments were lost or delayed.

### Strategies

The issue of strategies is very much tied to the issue of power, according to our exchange network model. Since power relative to the input relations themselves is best studied on a case by case basis, so are the associated strategies (i.e. power balancing activities). We can, however, make some general observations about the interorganizational strategies used by investors. As always, the manipulative strategies-- i.e. contacts with key officials--seem to be helpful. Unfortunately, NZ FOODCO has not been able to use this strategy against problems arising from the transportation infrastructure. Not even its Hong Kong contacts, which have proven helpful in the past, are effective against these transportation problems.

There are other ways, too. One such way which was not specifically identified by our model is to bypass the power of the State in the interorganizational network.

Specifically, a company can avoid import controls by assembling products within China. NZ TECHCO plans to bypass import licensing requirements and import taxes by assembling its products within China. Currently, NZ TECHCO's wholly foreign-owned subsidiary deals only in the marketing of its products. Recent Provisions promulgated by the State Council should also help reduce problems associated with importing by exempting foreign invested firms from import tariffs on certain items.

### Labor Relations

#### The Exchange Relation

One of China's major attractions to foreign investors is its abundant labor supply. Labor is sometimes provided by the Chinese partner as part of the original joint venture agreement, and other times it is not. When labor is not part of the original agreement or when additional labor is needed, the foreign investor and the Chinese partner must engage in labor exchange relations. Monetary concession is paid either to a labor agency or directly to the employee in exchange for work.

### Power Differentials

The Chinese State controls the allocation of the majority of the domestic labor force. In Beijing and Shanghai, for example, the Foreign Enterprise Service Company (FESCO) controls the allocation of labor. (Workers are actually considered employees of FESCO and not the foreign enterprise itself). By virtue of its preeminent position in socialism, the State has the power to authoritatively structure the labor market. The foreign investors' interorganizational powers relative to the State are negligible. Furthermore, the authoritative structuring of the labor market has limited the number of alternative sources of labor for investors. Thus, investors and their enterprises can easily become dependent upon the State; the degree of their dependency being largely determined by the essentiality of labor to their operations.

For example, according to the Provisions of the State Council for the Encouragement of Foreign Investment, foreign invested firms are also allowed to hire directly local and non-local workers, or to recruit them through hiring agencies. However, at the present time, these options are effectively negated by the amount of red tape involved. Salem (1986) wrote that "current practice makes

recruitment and transfer of non-local personnel an exercise in futility" (p. 49). Consequently, as mentioned above, the investor is for the most part dependant upon the State.

A degree of dependency also exists in the reverse direction. From the foreign investors point of view, the labor relation is based on an exchange of money for labor. The State labor agencies, on the other hand, view foreign investment as both a source of money, and more importantly, as a source of employment for the Chinese people. This is due to the State's traditional socialist obligation to provide employment for its workers. However, the seriousness with which the State labor agencies take this obligation is arguable. Moreover, these labor agencies, by virtue of their exclusive position, appear to have quite a few sources of employment. The dependency of the State labor agencies on foreign investors is relatively small in comparison to the foreign investors' dependency on the State, and as a result, the overall balance of power in these relations favors the State agencies.

The government's virtual monopoly on labor (and the investor's lack of power) can sour a foreign investor's labor relations. One of the major complaints of investors is directed at FESCO's monoploy of the labor market. This allows FESCO to set wage rates many times higher than the

local rate. Furthermore, the fact that foreign investors are required to make payments directly to FESCO and not to the employees undermines any attempts by investors to establish salary and bonus incentive programs (Sterba, 1986b; Schiffman, 1986).

Labor relations also have a tendency to become less beneficial to the foreign investor for two additional reasons: workers are often times unproductive or of low quality, and the State tends to use its authoritative powers to overstaff joint ventures. Both these factors further increase the cost of the relationship for the investor. The problem is compounded by the fact that there are a number of administrative obstacles to dismissing unproductive or even redundant workers. The NZ FOODCO executive noted that quite a few of their Chinese workers played more than they worked. This may have been due to the fact that the milling factory was overstaffed. Workers, according to the executive, would just turn up unannounced. These workers were most likely assigned to the factory by outside Party organizations, despite State Council directives forbidding such outside meddling in joint venture management. However, because NZ FOODCO considers labor costs to be low in China, their labor relations have not yet become unbeneficial.

Moreover, some investors are forced to recruit personnel from other local sources or from abroad because government labor agencies are not capable of meeting all of the needs of foreign investors, particularly when they require personnel with managerial and technical skills. However, due to government restrictions, recruitment of personnel from other local sources can be a difficult undertaking. When the Shekou Labor Service Company was unable to provide the Guangdong Float Glass Company with qualified managers, the joint venture attempted to recruit qualified Chinese personnel itself. GFG interviewed a total 350 persons from the Beijing area of which 30 were qualified. Unfortunately, the work units of ten of these people refused to let them go (Weil, 1987). The second alternative, recruiting foreign expatriates, can be a costly endeavor since they usually command higher salaries.

### Strategies

Network extension is one strategy used by investors to reduce their dependency on the State labor agencies. Although there are relatively few alternatives, they do exist. NZ TECHCO, for example, has completely avoided using FESCO as a source of labor. Instead, the New Zealand company employs two expatriate New Zealanders, a Chinese



college student, and a retired Chinese gentlemen. All of these employees lie outside the control of government labor agencies; hence, NZ TECHCO is not dependent upon FESCO. The NZ TECHCO executive has also mentioned the possibility of hiring unemployed graduates in the future. While this is a viable option, many companies who have hired unemployed graduates often see them leave for supervisory positions in collective enterprises after having invested time and money in their training.

The power differentials in the labor exchange network heavily favors the State labor agencies. This allows the State to limit the number of alternative labor sources available to investors and thus further increase their dependency. NZ TECHCO has managed to avoid FESCO's monopoly, but then again it is a small operation. It is doubtful whether larger firms that require large numbers of workers (i.e. labor is highly essential) could do the same. Sometimes companies have no choice but to seek out workers from obscure and difficult, or expensive sources because the State is unable to meet all of their labor needs. So far, State labor agencies have been able to use their exclusive positions to charge higher wage rates. Complaints from investors have been acknowledged by high officials, and may facilitate the lowering of wage rates in the future.

## Land Relations

### The Exchange Relation

In addition to labor, land is another basic resource sought by foreign investors. As a socialist nation, the Chinese State maintains control of all its land; land cannot be bought, only leased. Land relations are therefore based on the exchange of the right to use or lease land in return for monetary concession. The services or technology of certain foreign investors is of such importance to the modernization programs of some provinces or municipalities in China that the State or local government authorities will provide land free of charge, although this is the exception rather than the rule.

### Power Differentials

In considering the dependency of foreign investors in their land relations, it is quite clear that the number of alternative source of land is limited. Land relations in China are perhaps even more restrictive than labor relations. Once foreign investors decide to set up enterprises in China, the State is their only source of land. Even so, a certain degree of competition still exists in China. The different provinces, municipalities, and

autonomous regions offer various land-use incentives in order to attract foreign investment. The question of essentiality of land is best answered on a case by case basis depending upon the nature of the individual enterprise; some firms require only a few square meters of office space while others require much larger areas. In general, due to the limited number of alternatives, foreign investors appear to be in a dependent position.

A reverse dependency, i.e. that of the State on the foreign investors, is not likely since the State has many customers and the resources offered by the investors (typically monies) are not indispensable. The power balance in these land relations thus favors the State or its local authorities.

A general complaint lodged by investors, particularly during 1986, concerned high land-use fees. The problem is particularly acute in Beijing where many companies set up offices in order to maintain contacts with ministries and other organizations. A survey conducted by Campbell (1986) found that the biggest items on the budget for offices in Beijing were office and living accommodations. He noted that rental costs can easily run above \$100,000 per year. Moreover, since leases are typically short-term, and since the Beijing Municipal

Pricing Bureau can impose rent increases, the rental costs are never certain. High rental costs are simply a reflection of high demand and limited supply. In other words, the Beijing authorities can exploit the competition between foreign investors for valueable office space.

### Strategies

Foreign investors find themselves at a power disadvantage relative to both their land exchange relations and networks. The only strategy used thus far by foreign investors in regard to high rental rates has been to lodge formal complaints with the government in hopes of obtaining official relief. These complaints are usually made along with a number of others, such as those concerning high labor cost, foreign exchange restrictions, and bureaucratic stalling. In one particular instance, glimpses of a coalition formation strategy appeared. A coalition of American business executives and US government officials circulated a document around Beijing in mid-1986 describing what was wrong in China's business environment (Sterba, 1986c). These complaints have not gone unnoticed. The State has promulgated provisions which address these general problems, including rental rates. Investors, however, are taking a wait and see attitude toward the State's actions.

## Output Relations

### The Exchange Relation

Chossudovsky (1986) argued that transnationals invest in foreign countries in order to penetrate the foreign domestic market and to produce, process or assemble products for export markets using the cheap foreign labor. All of the investor's other relations are ultimately aimed at accomplishing these output relations. Output relations are typically based on an exchange of a firm's products for monetary concession. The money accrued from these output relations helps fund further production, pays debts, and provides profit to the owners or investors. In other words, output relations create capital accumulation for investors.

### Power

Output relations, like input relations, vary according to the products being traded and to whom they are being traded. Power differentials within these relationships are best studied on an individual basis. Nonetheless, we can identify some general factors in the investor's environment that affect their power. Since, the critical and most desired market for many investors is not

the export market, but the domestic market, we shall focus our attention on the power differentials within these relations and networks.

As in many of the investor's other exchange networks, the Chinese government has used its authoritative powers to structure the domestic market. China's concern with the domestic market stems from its concern over the lack of foreign exchange in the country. Foreign invested firms which sell their products to the domestic market repatriate their profits overseas in the form of foreign exchange. In order to prevent this outflow of foreign exchange, the government has restricted access to the domestic market, and as we saw earlier, regulated foreign exchange relations.

According to our exchange network model, dependency is a reflection of the number of alternatives available, and the essentiality of the resource exchanged. Since the governmental structuring of the domestic market has noticeably limited the number of potential customers for investors, dependency for the investor is largely based on the essentiality of the resources offered by their customers. Customers who can offer foreign currency rather than renminbi in exchange for goods possess a more essential resource.

Of course, a certain amount of competition for products does exist among government bureaus as well as private concerns. NZ FOODCO and NZ TECHCO, for example, both sell their ventures' products on the domestic market. In fact, both of the executives from the New Zealand companies mentioned that the State was allowing their ventures to actively seek out customers, thus creating more alternatives and reducing their dependency.

The authoritative structuring of the domestic market could also work to increase the dependency of local customers on foreign investors. That is, if the State only allows a limited number of foreign firms to sell to the domestic market, then the domestic market only has a limited number of alternative sources from which to purchase products, especially since the Chinese government is trying to avoid imports. Thus, if the foreign investor offers an essential resource and their customers have limited alternative sources, the customer will become dependent. This situation is most likely to occur in exchanges involving high technology items since high technology items are usually essential and have limited sources within China.

The power balances within individual output relations are very much case specific. From our above discussion, it appears as though there is no systematic bias in the power balances of these relationships. A power imbalance does, however, exist in the interorganizational environment, i.e. the State has the power to authoritatively structure the domestic market.

Moreover, output relations can be hampered by China's inadequate transportation infrastructure. NZ FOODCO's reasons for producing only animal feed premixes and not the whole feed stem in part from the inadequate transportation system in China. The Chinese transportation system is unable to transport large quantities of feed at a cost effective rate. NZ FOODCO has therefore opted to produce only the premix portion of the feed since it makes up only one third the total volume of the whole feed. This portion can be shipped at cost effective rate. In addition, the premix is the most expensive and technically complex portion of the feed; the joint venture's power in its exchange relation derives from the production of this essential and exclusive resource. The remaining portion of the feed--the grain--can be purchased from numerous other sources.



## Strategies

Time and time again, foreign investors have demanded the right to sell on the Chinese market and to repatriate profits quickly. "John Calverley, senior economist with American Express, said producing for the domestic market and not for export is the attraction for investors in countries such as China, Brazil, and Mexico" ("Peking Admits," 1987, p.11). As testimony to the investors' powerlessness over their output networks, the Chinese government has been reluctant to make concessions to them on these points. Investors must therefore work within the limits defined by the State. For example, Hong Kong firms tend to totally ignore the highly structured domestic market and produce solely for export markets using the cheap Chinese labor (Salem, 1987).

## CHAPTER 6: CONCLUSIONS

This paper has attempted to analyze direct investment from an exchange network perspective. The power differentials in each of the investor's six primary relationships have been identified along with the strategies investors used in relation to these differentials. A summary of our findings is shown in Tables II and III. Table II shows the power differentials which exist in each of the investor's six relationships and their related networks. From this table, we can see that foreign investors hold the balance of power in their joint venture relationships. We can also see that investors are generally in a position of dependency and power disadvantage in their capital, labor, and land relations. The power balance in input and output relations is too case specific to generalize about. Similarly, whether or not an investor has garnered any interorganizational power is best examined on a case by case basis. However, one fact is definitely clear, the Chinese State exercises considerable power over the investor's entire environment.

TABLE II  
SUMMARY OF POWER DIFFERENTIALS IN EXCHANGE RELATIONS

		<u>Alterna-</u> <u>tives</u>	<u>Essentiality of</u> <u>other's resource</u>	<u>Dependency</u> <u>on relation</u>	<u>Netwk</u> <u>Power</u>
<u>Productive</u>	*F:	numerous	non-essential	NO	c.s.
	P:	limited	essential	YES	c.s.
<u>Capital</u>					
<u>foreign</u>	F:	limited	hi essential	YES	c.s.
<u>exchange</u>	*P:	numerous	non-essential	NO	c.s.
<u>loans</u>	F:	limited	hi essential	YES	c.s.
	*P:	numerous	essential	NO	YES
<u>Input</u>	F:	c.s.	c.s.	c.s.	c.s.
	P:	c.s.	c.s.	c.s.	c.s.
<u>Labor</u>	F:	limited	c.s.	YES	c.s.
	*P:	numerous	non-essential	NO	YES
<u>Land</u>	F:	limited	c.s.	YES	c.s.
	*P:	numerous	non-essential	NO	YES
<u>Output</u>	F:	c.s.	c.s.	c.s.	c.s.
	P:	c.s.	c.s.	c.s.	c.s.

F: foreign investor  
P: exchange partner

c.s.: case specific, i.e. depends upon individual investor;  
generalizations are difficult to make

\*favored by balance of power in exchange relation itself

note: interorganizational power favors the Chinese State in all  
six exchange networks, although some organizations may exercise  
power through contacts with it.

TABLE III  
SUMMARY OF STRATEGIES EMPLOYED BY  
FOREIGN INVESTORS IN STUDY

	<u>General Problems</u>	<u>Origins of problem</u>	<u>Network Strategy</u>	<u>Interorg. Strategy</u>
1. Productive	regulations & bureaucracy	State restriction of network	withdrawal	manipulative (contacts w/ officials)
2. Capital				
foreign exchange	limited alternatives	State restriction of network	network extension	manipulative (contacts w/ officials)
loans	strict requirements	simple dependency	network extension	-
3. Inputs	import controls; bureaucracy	State restriction of network	-	manipulative bypass State controls
4. Labor	high costs	State restriction & monopoly	network extension	manipulative (lobbying)
5. Land	high costs	State monopoly of resource	-	manipulative (lobbying)
6. Output	domestic mkt restricted	State restriction of network	-	manipulative (lobbying)

The State's power to condition the investment environment translates into numerous problems for foreign investors, as can be seen in Table III (see "origins of problems"). First, the State can dictate the structure of exchange relations. This tends to limit the number of alternatives available to investors and create dependencies. This has occurred in the land, labor, and foreign exchange relations of foreign investors. Authoritative structuring of exchange networks also keeps investors out of the much desired domestic market. Second, the State's involvement in the investment environment has created restrictions on the flow of resources within networks and between exchange partners. Resource flow is typically interrupted by numerous regulations and a cumbersome bureaucracy which often experiences in-fighting.

The State's prominent position in the investment environment accounts for another important fact about direct investment in China. Namely, the manipulative strategy is an important strategy for investors. From Table III, we can see that foreign investors often resort to this strategy. Lobbying government officials as a form of manipulation has had some limited success, but the so-called "trump" for investors is political support, i.e. direct or indirect contacts with government officials or

Party cadre. These linkages with the external environment allow foreign investors to manipulate the flow of resources in their networks. The effectiveness of this strategy was demonstrated in the AMC case.

The two New Zealand companies interviewed in this study remarked on the invaluable role expatriate Chinese had played in overcoming bureaucratic and regulatory problems. Within the context of China, the Chinese expatriate bourgeoisie is the class which plays an instrumental role in the manipulative strategy. expatriate Chinese have established a strong economic base in Hong Kong, Taiwan, and Singapore. Moreover, the Chinese merchant bourgeoisie are also part of the economic elite in Thailand, Indonesia, Malaysia, and Burma. "These national groups of Chinese extraction are not isolated from one another: the Chinese (expatriate) bourgeoisies in the various countries in South-East Asia are integrated both in commercial, banking and financial undertakings as well as through family and class ties" (Chossudovsky, 1986, p.141).

As Chossudovsky noted (1986), the expatriate bourgeoisie plays an important role in the process of class formation in post-Mao China. Linkages between the expatriate bourgeoisie and China are quite evident. First, the Chinese expatriate bourgeoisie is linked to China

economically as well as through family and class ties. They provide a "vital link" to the establishment of trade, joint ventures, and other commercial undertakings. Furthermore, senior members of the Chinese Communist Party (CCP) enjoy privileged connections with members of the Hong Kong expatriate bourgeoisie. Chossudovsky argues that there is evidence showing the involvement of Hong Kong 'compatriot' capitalists in the formulation of China's foreign investment policy.

Another noteworthy trend which is occurring in China is decentralization of the economy. Such decentralization is advantageous to foreign investors since it diminishes the the State's centralized powers and creates competition between provinces, municipalities, and autonomous regions. The competition within China to attract foreign capital using various incentives such as reduced land-use fees and low tax rates, and the competition between State supply agencies is a reflection of this trend. The power of investors will increase as this competition intensifies. However, the degree to which the Chinese State decentralizes its control depends largely upon the political strategies of its leadership.

In conclusion, the majority of problems which arise in the investor's environment can be traced back to the

Chinese State and its authoritative powers. The State not only restricts the flow of resources within exchange networks, but also structures networks so as to place investors in positions of dependency and powerlessness. It is the lack of power on behalf of investors which inhibits them from controlling their exchange relations and more fully establishing themselves in China. Foreign investors have attempted to increase their power, and therefore their freedom of action, in their exchange networks by employing power-balancing strategies (specifically network extension) and manipulative strategies. As suggested by our model, direct contacts with Chinese officials or indirect contacts through the expatriate Chinese class will play an important role in increasing the power of foreign investors in the future, and thereby facilitate the penetration of China by core states. Moreover, the decentralization of China's economy should favor the investor as the State's power in the investment environment declines.



## APPENDIX A

## Interview Schedule

## I. General Information

## A. Foreign Company

1. Name
2. Location
3. Size of Company
  - a. Divisions
  - b. Personnel
4. Major Activities/Objectives
5. Cross-National Status
6. Target Markets

## II. Investment Motivation

## A. Expectations

1. Original
2. Future

## B. Reasons For Investment

1. Raw Materials
2. Labor
3. Land
4. Markets
5. Tax Incentives
6. Other

## III. Exchange Relations

## A. Joint Venture

1. Name
2. Partner(s) Name and Sponsor in China
3. Location
4. Legal Format
5. Duration
6. Business Scope (Major Activities/Objectives)
7. Target Markets
  - a. Domestic
  - b. International
8. Investment Contribution
  - a. Proportion (Each Partner)
  - b. Form of Contribution (Each Partner)
  - c. Alternatives Sources
    - 1) Domestic
    - 2) International

- d. Substitutability
  - 1) Essentiality of Contribution
  - 2) Feasable Substitutes
- 9. Difficulties in Relation
- 10. Strategies
  - a. Alternatives
  - b. Substitutes
- 11. Perceived Value of Relation to Company
- 12. Approval Procedures
  - a. Organizations Involved
    - 1. Company Representative
    - 2. Chinese Govt
    - 3. Others
  - b. Difficulties/Delays
    - 1. Bureaucratic
    - 2. Contractual
    - 3. Cultural
  - c. Interorganizational Strategies
    - 1. Chinese Govt Contacts
    - 2. Other Chinese Contacts
    - 3. Home Country Govt Contacts
    - 4. Other Home Country Contacts
- B. Capital Acquisition (foreign exchange, loans)
  - 1. Sources of Capital/ Competition
    - a. Alternatives
      - 1) Domestic
      - 2) International
    - b. Essentiality
  - 2. Difficulties in Relation
  - 3. Strategies
    - a. Alternatives
    - b. Substitutes
  - 4. Perceived Value of Relation to Company (Mutual Benefit?)
  - 5. Network
    - a. Govt Restrictions (regulations, bureaucratic)
    - b. Others (e.g. infrastructure, etc)
    - c. Strategies
      - 1). Chinese Govt Contacts
      - 2). Other Chinese Contacts
      - 3). Home Country Govt Contacts
      - 4). Other Home Country Contacts
- C. Input Relations (raw materials, parts, etc)
  - 1. Suppliers of Raw Materials/Competition for Raw Materials
    - a. Alternatives
      - 1) Domestic
      - 2) International
    - b. Essentiality
  - 2. Difficulties in Relation

- 3. Strategies
    - a. Alternatives
    - b. Substitutes
  - 4. Perceived Value of Relation to Company (Mutual Benefit?)
  - 5. Network
    - a. Govt Restrictions (regulations, bureaucratic)
    - b. Others (e.g. infrastructure, etc)
    - c. Strategies
      - 1). Chinese Govt Contacts
      - 2). Other Chinese Contacts
      - 3). Home Country Govt Contacts
      - 4). Other Home Country Contacts
- D. Labor Acquisition
- 1. Sources of Labor/Competition for Labor
    - a. Alternatives
      - 1) Domestic
      - 2) International
    - b. Essentiality
  - 2. Difficulties in Relation
    - a. Quality of work force
    - b. Autonomy in personnel matters
  - 3. Strategies
    - a. Alternatives
    - b. Substitutes
  - 4. Perceived Value of Relation to Company (Mutual Benefit?)
  - 5. Network
    - a. Govt Restrictions (regulations, bureaucratic)
    - b. Others (e.g. infrastructure, etc)
    - c. Strategies
      - 1). Chinese Govt Contacts
      - 2). Other Chinese Contacts
      - 3). Home Country Govt Contacts
      - 4). Other Home Country Contacts
- E. Land Acquisition
- 1. Sources of Land-Use/Competition for Land
    - a. Alternatives
      - 1) Domestic
      - 2) International
    - b. Essentiality
  - 2. Difficulties in Relation
    - a. Land-use Fees
    - b. Infrastructure
      - communications
      - energy
  - 3. Strategies
    - a. Alternatives
    - b. Substitutes

- 4. Perceived Value of Relation to Company  
(Mutual Benefit?)
- 5. Network
  - a. Govt Restrictions (regulations, bureaucratic)
  - b. Others (e.g. infrastructure, etc)
  - c. Strategies
    - 1). Chinese Govt Contacts
    - 2). Other Chinese Contacts
    - 3). Home Country Govt Contacts
    - 4). Other Home Country Contacts

F. Output Relations

- 1. Markets for Products/Competition
  - a. Alternatives
    - 1) Domestic
    - 2) International
  - b. Essentiality
- 2. Difficulties in Relation
- 3. Strategies
  - a. Alternatives
  - b. Substitutes
- 4. Perceived Value of Relation to Company  
(Mutual Benefit?)
- 5. Network
  - a. Govt Restrictions (regulations, bureaucratic)
  - b. Others (e.g. infrastructure, etc)
  - c. Strategies
    - 1). Chinese Govt Contacts
    - 2). Other Chinese Contacts
    - 3). Home Country Govt Contacts
    - 4). Other Home Country Contacts

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